Is A CGL Policy Still Worth Having?

By Wayne Maiorano and Alan Parry

It is well established that an insurer generally has two duties to an insured contractor under a commercial general liability ("CGL") policy—a duty to defend and a duty to indemnify against losses. In general terms, coverage is controlled by the language of the policy and the application of that language to the facts. In assessing whether coverage exists for a claim made under a CGL policy, an insurer must consider many things, including: Who is an insured under the policy? Does the claim arise from a covered event? Did the alleged damages occur within the policy period? What damages are covered? Who did the allegedly defective work at issue? Does any exclusion apply to deny coverage?

The duty to defend is generally much broader and easier to trigger than the duty to indemnify. Unlike the duty to indemnify, the duty to defend can be triggered without the insurer having a full understanding of the underlying claims and damages. Instead, the insurer must simply look to the allegations in the complaint asserted against the contractor and determine whether any claim, if it were meritorious, could potentially trigger coverage. If so, then the insurer must provide the contractor with a defense. Given the insurer's duty to investigate claims, the duty may be triggered even where the complaint may not reveal a potentially covered claim, but where the insurer knows or could reasonably ascertain facts that, if proven, would be covered by the policy. See **Waste Management of Carolinas, Inc. v. Peerless Ins. Co.**, 315 N.C. 688, 340 S.E.2d 374 (1986).

In light of the relatively low threshold triggering an insurer's duty to provide the contractor with a defense and the potential risks arising from denying a defense, insurers traditionally accept, pursuant to a reservation of rights, the contractor's defense. One practical implication of the insurer's providing the contractor with a defense is that the parties to the underlying dispute, more often than not, settle the claims with payment coming, in whole or in large part, from the insurer on behalf of the contractor. So common is this process that the parties to these disputes often take it for granted that the insurer will aid in the settlement of the claims regardless of whether potentially viable grounds for denying coverage exist.

Is this expectation in jeopardy? Perhaps, as it would appear that North Carolina courts are taking an increasingly narrow view of the protection afforded under a CGL policy in construction defect cases. Recently the Fourth Circuit significantly narrowed an insurance company's exposure to pay for damages under the policy where such damages were alleged to be caused by the contractor's poor workmanship. **Travelers Indem. Co. v. Miller Bldg. Corp.**, 221 Fed.Appx. 265 (4th Cir. 2007)(unpublished). While not a novel application of the law, the decision may reflect the increasing difficulty that a contractor will have obtaining help from its insurer when confronted with a construction defect claim.

Background

Miller Building Corp. ("Miller") was hired by PVC, Inc., the owner/developer, to construct the Holiday Inn Sunspree at Wrightsville Beach. The hotel was completed and opened for business in the summer of 1999. In September 2000, Miller initiated arbitration proceedings against PVC to collect the contract balance. PVC asserted counterclaims, contending that it encountered problems created by Miller's defective workmanship from the time the hotel opened. PVC argued that Miller's mistakes had led to serious problems, such as cracking and buckling of the hotel's concrete framework and water leaking into the hotel, resulting in damage to the building's interior. Miller had a standard CGL policy issued by Travelers Indemnity Company ("Travelers"). Miller tendered the defense and indemnification of PVC's claims to Travelers. A dispute arose between Travelers and Miller concerning coverage under the CGL policy and Travelers filed a declaratory judgment action seeking a determination that it had no duty to defend or to indemnify Miller in its dispute with PVC.

Travelers I

The first time that this matter was before the Fourth Circuit, the court's analysis focused on whether Travelers was obligated to provide Miller with a defense under the policy. **Travelers Indem. Co. v. Miller Bldg. Corp.**, 97 Fed. Appx. 431 (4th Cir. 2004) (unpublished)("**Travelers I**"). Travelers claimed that Miller's poor workmanship did not constitute "property damage" arising out of an "occurrence." The policy defined "property damage" to mean "physical injury to tangible property, including all resulting loss of use of that property." The District Court agreed and granted Travelers' motion for summary judgment, concluding that there was no possible coverage under the policy and, thus, no duty to defend Miller in its suit with PVC.

On appeal, the Fourth Circuit vacated and remanded the case to the District Court, holding that, because the complaint arguably stated a claim for an injury that would be covered by the policy, the duty to defend was triggered, whether or not Travelers would ultimately be found liable on that claim. In so holding, the Fourth Circuit acknowledged that, because the construction performed by Miller was alleged to be defective, the hotel itself was not "delivered" in an undamaged condition and would not be covered by the policy. The court, however, distinguished between contractor-supplied and owner-supplied property to determine that some aspect of PVC's claimed damages may, in fact, be covered under the policy. In particular, the court pointed to PVC's claim that the guest-room carpeting was damaged by the moisture intrusion that occurred as a result of the purported construction defects. Because the carpeting was provided by PVC to Miller in a previously undamaged condition, the court found that the damage to the carpeting was both an "occurrence" and was damage to property separate from the hotel that could possibly fall within the policy's definition of "property damage." Accordingly, the Fourth Circuit held that Travelers had a duty to defend Miller against PVC's claims.

Amerisure

After the decision in **Travelers I,** the North Carolina Court of Appeals further clarified the extent of coverage under a CGL policy in the context of allegations of faulty workmanship by an insured contractor. **Production Sys. Inc. v. Amerisure Ins. Co.**, 167 N.C. App. 601, 605 S.E.2d 663 (2004). The **Amerisure** case involved an improperly installed oven feed line system that caused damage to other parts of the line, resulting in the line not functioning properly. The court made it clear that the term

"property damage," as it was defined by the policy, meant damage to property that was previously undamaged, and does not include the expense of repairing property or corrections to parts of the project that were done incorrectly by the contractor in the first place. The court concluded that there was no "property damage" to the oven feed line system because the only "damage" was repair of defects in the line as a result of the poor workmanship in the construction of the line. Therefore, the court affirmed the trial court's granting of summary judgment to the insurer because nothing triggered the insurance carrier's duty to defend or indemnify the insured contractor.

Travelers II

After the Fourth Circuit remanded the case to the District Court in **Travelers I,** Travelers filed a motion for summary judgment, seeking a declaration that coverage under the policy was limited to physical injury to tangible property that was separate from the hotel and delivered to Miller in an undamaged condition. Miller had filed a motion to stay the declaratory judgment action until the pending arbitration could be concluded, on the ground that the District Court should not define the scope of the insurance coverage until the cause and extent of PVC's damages had been determined in the underlying liability action between PVC and Miller. Despite Miller's pending motion to stay, the District Court granted Travelers' motion before the arbitration had run its course.[1] The District Court held that Travelers' coverage extended to damage to property separate from the hotel, the occurrence of which was not subjectively foreseeable by Miller. Travelers would be responsible for consequential damages for loss of use of property separate from the hotel as well, unless Miller failed to perform its construction contract with PVC according to the contract's terms. Finally, Travelers' coverage did not include consequential damages from the delay in opening the hotel. Miller appealed the District Court's grant of summary judgment.

While acknowledging that the District Court's ruling on coverage prior to the resolution of the underlying action was somewhat atypical, the Fourth Circuit emphasized that there may be occasions when the court can "materially advance the litigation by deciding the legal outlines of coverage prior to the completion of litigation over particular items of damage." **Travelers Indem. Co. v. Miller Bldg. Corp.,** 221 Fed.Appx. 265, 268 (4th Cir. 2007)(unpublished)("**Travelers II**"). The court stated that "[b]ecause no substantive progress had been made in the arbitration proceedings between Miller and PVC, a prompt ruling on the scope of Travelers' indemnification obligation might also provide some guidance and structure for the arbitration proceedings." Id. Thus, the Fourth Circuit determined that the declaratory judgment was timely and that it was appropriate for the District Court to define the limits of coverage under the policy even at a relatively early stage of the underlying proceeding.

In affirming the District Court's ruling, the Fourth Circuit relied heavily on the North Carolina Court of Appeals' decision in **Amerisure.** The court emphasized that "North Carolina law would severely limit the type of damage for which the insured would be indemnified." **Travelers II,** 221 Fed.Appx. at 268. Accordingly, the Fourth Circuit held that "to the extent that [PVC] is seeking to recover from Miller the cost of correcting Miller's faulty workmanship, the claims do not fall within the scope of the policy issued by Travelers, because faulty workmanship does not constitute 'property damage.'" *Id.* at 269 (citing **Travelers I.**)

However, the Fourth Circuit did not address the fact that the **Amerisure** court was not required to determine whether damage to separate tangible property (which was previously undamaged) was covered under the policy, as was the situation in the **Travelers** cases. Further, the Fourth Circuit's opinion lacks a clear explanation of what happened to the carpet damage claim that it had found so significant during its first review of this dispute. This lack of clarity could cause potential confusion in the future interpretation and application of the decision. Unfortunately, the District Court's opinion triggering the second appeal was not published. Only after reviewing the District Court's order and the parties' briefs filed with the Fourth Circuit does it become apparent that the District Court concluded that Travelers remained potentially obligated to Miller under the policy for PVC's carpet damage claim. Both the Fourth Circuit opinion and the District Court order, however, are silent as to the scope of Travelers' duty to defend Miller in its dispute with PVC. Presumably, Travelers was required to defend Miller against all of PVC's claims, despite the court's ruling limiting Travelers' potential coverage obligation to just those damages to property separate from the hotel.

So What Does It Mean?

Arguably, it is bad public policy to require insurance companies to relieve contractors of their responsibility to fully and properly perform their work, or from the repercussions of failing to do so. This is certainly reflected in North Carolina case law, where it is well understood that liability insurance is not a substitute for a performance bond. See, e.g., **Western World Ins. Co. v. Carrington,** 90 N.C. App. 520, 369 S.E.2d 128 (Ct. App. 1988) ("Since the quality of the insured's work is a 'business risk' which is solely within his own control, liability insurance generally does not provide coverage for claims arising out of the failure of the insured's product or work to meet the quality or specifications for which the insured may be liable as a matter of contract."); **Hobson Construction Co., Inc. v. Great American,** 71 N.C. App. 586, 322 S.E.2d 632 (Ct. App. 1984) (the cost to repair defective work is not covered "property damage" under a CGL policy). Nonetheless, an allegation of resulting damage to separate tangible property generally would trigger a duty to defend, if not the duty to indemnify. See, e.g., **Wm. C. Vick Construction Co. v. Penn Nat. Mut. Cas. Ins. Co.,** 52 F.Supp.2d 569 (W.D.N.C. 1999) (while defective construction, in and of itself, should not be considered accidental for coverage purposes, damage to other property arising from the defective construction may constitute an "occurrence" that could trigger coverage under the policy).

The Fourth Circuit's decisions in **Travelers I** and **Travelers II,** however, reflect the increasing willingness of the courts to limit coverage under the standard CGL policy, and to do so earlier in the process. It is noteworthy that the Fourth Circuit emphasized the value of an early decision of the coverage issue, suggesting that this would influence the underlying suit and bring about a prompt resolution of the dispute. Considering the fact that the dispute between PVC and Miller was entering its seventh year, apparently with little progress, by the time the case returned to the Fourth Circuit, this may have been somewhat a result-oriented decision. Regardless, these decisions come with implications for the contractor and practitioner.[2]

Ultimately, contractors, as well as owners/developers, should not expect a CGL policy to cover damages to the contractor's work product as a result of poor workmanship or improperly built or installed materials.

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More importantly, the Fourth Circuit's recent decision should serve as a warning that an insurer can limit the scope of its indemnity obligation even during the early stages of the underlying liability action. Insurers may become more aggressive in denying a defense and coverage earlier in the process, transferring the burden to the contractor to take on two fights—one in defending against the underlying claims and one against the insurer in trying to obtain a defense and coverage. Because such a denial comes with some risk, it would be prudent for an insurer to seek a declaratory ruling from the court as to its duty to defend and limiting any potential indemnity obligation under the policy. Based upon the holdings in **Amerisure, Travelers I** and **Travelers II,** it now appears that the insurer will have greater motivation and legal support for obtaining such early decisions.

So, while a CGL policy remains an important part of any contractor's overall portfolio of insurance protection, the trend of court decisions in North Carolina (both state and federal) certainly calls into question a contractor's reliance on the CGL policy with respect to alleged construction defects claims. This trend may also lead to an increasing resistance by insurers to assist monetarily in reaching an early resolution on behalf of the insured contractor in construction defect cases, with insurers electing instead to obtain a ruling from the court on their defense and indemnity obligations. ■

MAIORANO IS A PARTNER AND PARRY IS AN ASSOCIATE AT SMITH, ANDERSON, BLOUNT, DORSETT, MITCHELL & JERNIGAN, LLP IN RALEIGH. BOTH ARE MEMBERS OF THE FIRM'S CONSTRUCTION PRACTICE GROUP. THEY CAN BE CONTACTED AT *WMAIORANO@SMITHLAW.COM* AND *APARRY@SMITHLAW.COM.* THE AUTHORS WISH TO THANK THURSTON WEBB, A 2007 SMITH ANDERSON SUMMER ASSOCIATE AND RISING 2L WAKE FOREST LAW STUDENT, FOR HIS ASSISTANCE WITH THIS ARTICLE.

Endnotes

1. The District Court's order highlighted the fact that Miller's counsel was not present at the hearing of Travelers' motion for summary judgment. Miller's counsel later said they did not receive notice of the hearing, but the district court proceeded with the hearing anyway. This apparently did not come up on appeal.

2. For example, the inherent tension and potential for conflict of interest that is faced by defense counsel retained by the insurer to represent the insured is well-documented in ethics rules and opinions. See, e.g., N.C. R. Prof'l Conduct 1.7 (and comments), 1.8(f)(2), 5.4(c), 03 FEO 12 (Oct. 22, 2004), 99 FEO 14 (Jan. 21, 2000), 98 FEO 17 (Jan. 15, 1999), RPC 56 (Apr. 14, 1989), RPC 91 (Jan. 17, 1991). The delicate balance between the defense lawyer's obligation to accept the instructions of the insurer when the insured has contractually surrendered control of the defense, on the one hand, and the lawyer's duty of loyalty to the insured, on the other, has become that much more difficult in the construction context. It is easy to see that the insured's and the insurer's interests can diverge when analyzing how to defend a construction defect case. While the practitioner owes a duty to both of its clients (the insured and the insurer), the practitioner may feel constrained when handling the case, such as in pursuing efforts to dismiss certain (potentially covered) claims, resulting in the only claims remaining in the case being those that are not covered under the policy, or determining the scope of discovery efforts that will ascertain the exact nature and cause of damages that could ultimately support the withdrawal of a defense and denial of coverage by the insurer or balancing an insurer's desire to resolve a matter quickly and minimize its costs with an insured's desire to defend itself fully and preserve its good name and reputation.